SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM
STAFF REPORT
FINANCE AND ADMINISTRATION DIVISION

Date: February 12, 2009

To: SDCERS Board of Administration

From: Mark Hovey, Chief Financial Officer M Hovey

Subject: Stan Keller's suggestion for actuary lead partner rotation

In his January 21, 2009 letter to David Wescoe, City Councilmember Faulconer asked for the SDCERS Board to consider "Mr. Keller's [the City's SEC Independent Consultant] suggestion for lead partner rotation in the event that an actuary is retained for more that [sic] 10 consecutive years." (See Attachment A for Councilmember Faulconer letter and related enclosures)

In connection with Mr. Keller's suggestion, I wanted to provide you with the following background information:

1. The City's Independent Budget Analyst, in IBA Report 08-120 "Information Related to Recommended Contracting Processes for Actuarial Services," cited no evidence that lead partner rotation is required or an actuarial best practice. (included in Attachment A)
2. In the research for my November 24, 2008 report to City Auditor Eduardo Luna regarding Kroll's recommendation to place a ten-year limit on continuous service on contracts for actuarial valuation services, I also did not find any "best practice" for lead partner rotation. (Attachment B)
3. "Best practice" on the retention of actuaries, according to both the IBA report and my research, is to conduct an actuarial audit every five years. The SDCERS Board approved a rule change in December 2008 that requires an actuarial audit should we retain the services of the same vendor for more than five years. An audit of Cheiron's upcoming June 30, 2009 valuation, their fifth, is tentatively scheduled for the spring of 2010. (Attachment C)
4. SDCERS and the Board did a comprehensive RFP for actuarial services when Cheiron was first selected in 2005. It was not only the expertise of Cheiron in general that led the Board to select them to perform SDCERS' valuations, but the expertise of Gene Kalwarski in particular. The forced rotation of the very expert from which SDCERS has received exemplary service over the past four years might arguably be said <u>not</u> to be a best practice.

Attachments

COUNCILMEMBER KEVIN FAULCONER

SECOND DISTRICT
CITY OF SAN DIEGO

January 21, 2009

Mr. David Wescoe
Administrator and CEO
San Diego City Employee's Retirement System
401 West A Street, Suite 400
San Diego, CA 92101

Dear Mr. Wescoe:

As you know, the Audit Committee of the City of San Diego previously expressed concerns about SDCERS' contracting policy for actuarial services in response to a Kroll Report recommendation that the SDCERS' actuary not be engaged for more than two consecutive five-year terms.

We were informed that the SDCERS Board approved a new contracting policy for actuarial services that would require an audit of the actuary's services by an independent actuarial firm if SDCERS retains the same actuary for a term beyond five consecutive years. While this does not comply with the Kroll Report recommendation, it is consistent with recommendations made by the City's Independent Budget Analyst in IBA Report 08-120.

The City's SEC Independent Consultant, Stan Keller, submitted the enclosed letter to the Audit Committee for our discussion of this matter at our meeting on December 1, 2008. In addition to concurring with the recommendation in IBA Report 08-120, Mr. Keller suggested that "if an actuary firm is renewed beyond 10 years of service, that the person responsible for managing the firm's provision of actuarial services to SDCERS be rotated."

A reconfigured Audit Committee (now comprised of three public members, Councilmember Carl DeMaio and myself as chair) discussed the SDCERS Board's new contracting policy for actuarial services at our meeting on January 12, 2009. The Committee asked if the SDCERS Board had considered, or would further consider, Mr. Keller's suggestion for lead partner rotation in the event that an actuary is retained for more that 10 consecutive years.

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I have made time on future Audit Committee agendas to discuss this matter until it is resolved. I request that you or a representative attend to give us SDCERS' position on lead partner rotation at one of these meetings. Our next two meetings will be held on January 26, 2009 and on February 23, 2009. Thank you for you attention to this matter. I look forward to your response.

Sincerely,

Council President Pro Tem Kevin Faulconer
Audit Committee Chairman

Encl: Stanley Keller's letter dated November 25, 2008
IBA Report 08-120

cc: Honorable Carl DeMaio, Councilmember
Andrea Tevlin, Independent Budget Analyst
Stanley Keller, Independent Consultant
Steve Grant, Audit Committee Member
Wade McKnight, Audit Committee Member
Charles Sellers, Audit Committee Member

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November 25, 2008

Kevin Faulconer
Chairman, Audit Committee
City of San Diego
202 C Street, MS #10A
San Diego, CA 92101

Dear Council Member Faulconer:

I am writing with respect to IBA Report No. 08-120 (the "Report") relating to the contracting for actuarial service by SDCERS, a topic which was the subject of a Kroll Report recommendation.

I concur in the recommendation of the IBA set forth in the Report. In addition, I would suggest that the SDCERS Board be asked to consider identifying as one of the criteria to be considered in the actuary selection process the benefits of turnover and, if an actuary firm is renewed beyond 10 years of service, that the person responsible for managing the firm's provision of actuarial services to SDCERS be rotated. In this way, the treatment of actuarial services to ensure independence and objectivity would be aligned with the approach established for selection of the City's outside auditor. Moreover, SDCERS would be in the leadership in promoting best practices in actuary retention, a subject of special importance to the City.

Very truly yours,

Stanley Keller
Independent Consultant

SK/kef
cc: Jay Goldstone, Chief Operating Officer
Andrea Tevlin, Independent Budget Analyst
Jeff Kawar, Fiscal & Policy Analyst
Michael Aguirre, City Attorney
David B. Wescoe, Administrator/CEO, SDCERS

BOS111 12335628.1

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: November 24, 2008 **IBA Report Number:** 08-120

Audit Committee Docket Date: December 1, 2008

Item Number: # 8

Information Related to Recommended Contracting Processes for Actuarial Services

OVERVIEW

At the Audit Committee meeting on October 6, 2008, Internal Auditor staff presented their review of internal control remediations that had been identified for the San Diego City Employees Retirement System (SDCERS). The issue of appropriate practices for contracting for actuarial services was discussed as it related to a Kroll Report recommendation for SDCERS. The Audit Committee requested that the IBA work with the Internal Auditor to research information related to best practices for contracting for actuarial services. This report provides the results of that research.

FISCAL/POLICY DISCUSSION

Recommendation from the Kroll Report and SDCERS Response

The Kroll Remediation Plan presented to the City on August 8, 2006 provided over 100 recommendations for improving financial reporting and control processes. Several of these recommendations pertained directly to SDCERS. The following recommendation can be found on page 260 of the Kroll Report:

> "We also recommend that SDCERS rebid the contract for the performance of its actuarial valuation every five years and that the actuary not be engaged for more than two five-year terms. After an engagement for the maximum ten-year term, an actuary should be eligible to be considered for an engagement only after five years of no service to SDCERS."

The Kroll Report does not cite a source or reference for this recommendation and the IBA was unable to reach the Kroll consultants for comment. Kroll noted in their report, however, that they believed former SDCERS actuary Rick Roeder (of Gabriel, Roeder, Smith & Company) "failed to provide the objective, critical advice that could have protected the SDCERS Trust from the City's penchant for seeking to minimize its contributions to the System." Mr. Roeder was the SDCERS actuary for a 12-year period from 1992 to 2004. The SDCERS Board hired Cheiron to serve as it actuary since 2004 and recently renewed their contract for another three-year term (with a five-year renewal option).

In responding to the Internal Auditor and the Audit Committee regarding the above referenced Kroll recommendation, SDCERS CFO Mark Hovey indicated that the SDCERS Board did not support a maximum ten-year limitation. Mr. Hovey indicated that it was the Board's go-forward intention to vigorously rebid the actuarial contract every 5 years (his statement ties to a pending change to the SDCERS Board Rules for retaining service providers) and to always select the best qualified bidder. As noted by the Internal Auditor, the recently renewed contract with Cheiron has future renewal options do not comply with Board's go-forward policy intention or the Kroll recommendation.

<u>Research Related to Recommended Contracting Processes for Actuarial Services</u>
The IBA contacted several professional associations (Government Finance Officers Association, Society of Actuaries and the American Academy of Actuaries) and was unable to find a recommended best practice for hiring actuaries. The Audit Committee's professional audit consultant (Jefferson Wells) and the City's Independent Consultant (Stan Keller) were also asked if they knew of best practices for hiring actuaries. Mr. Keller consulted with McGladery & Pullen, his independent accounting consultant. These expert consultants were similarly unable to find or cite a best practice.

The IBA believes the absence of related best practices neither supports or refutes Kroll's recommendation. It could be that professional guidelines have yet to be established in this regard. Alternatively, it may be an acceptable practice to renew a contract with the same actuary for more than ten years provided that other safeguards exist for periodically checking their work. In reviewing other literature and viewpoints on this topic, <u>weaknesses</u> associated with using one actuary over an extended period of time include:

- Alternative assumption and valuation viewpoints are not heard.
- Unbiased peer professionals do not check actuarial methods.
- Actuaries may be influenced by their hiring boards – this concern may be real or perceived.

<u>Strengths</u> associated with using one actuary over an extended period of time include:
- Continuity and consistency of actuarial work.
- A more comprehensive understanding of complex plan provisions and the evolution of those provisions.
- Lower fees attributable to plan familiarity.

In order to provide peer agency perspective, the IBA worked with the Internal Auditor to survey the actuary hiring policies and practices of other large cities. The resulting information is provided in the table below.

City	Actuarial Contract Policy	Practice	Notes
Los Angeles	No	Adhere to city-wide policy which stipulates any contract longer than three years must be approved by Council	No limits on continuous service
San Francisco	No	Adhere to city-wide policy stipulates service agreements be reviewed every five years	No limits on continuous service - past 17 years Towers Perrin, Cheiron since 7/1/08
Phoenix	Yes	Board appoints the actuary and at its discretion, may solicit bids periodically for service	No limits on continuous service
Portland	No	No formal policy for hiring or retaining the actuary. Recently solicited bids and hired a new actuary	No limits on continuous service
San Jose	Yes	Board policy requires rebids every 8 years	No limits on continuous service
Seattle	No	No formal policy for hiring or retaining the actuary. Recently solicited bids and hired a new actuary	New firm has 4-year contract.
Kansas City	No	No formal policy for hiring or retaining the actuary. New firm hired in 2006	Has used same firm for over 20 years

Although the above is a limited sampling of other major cities, it should be noted that there are no limitations on continuous service for actuaries at these agencies.

<u>Actuarial Audits</u>
An actuarial audit is the scrutiny of one actuary's work by another actuary to ensure that actuarial valuations are performed correctly and that the methods and assumptions used are reasonable. Considering the financial objectives of the plan, an actuarial audit includes a critique of the plan actuary's judgment concerning the plan's exposure to risk.

The primary purpose of an actuarial audit is to verify that the actuarial work is accurate and the advice given is sound.

In light of Kroll's recommendation and the stated position of the SDCERS Board, the IBA believes that a comprehensive actuarial audit every five years would significantly address the concern behind the Kroll recommendation and be in keeping with the Board's preference not to have a continuous service limitation. The Government Finance Officers Association recommends actuarial audits at least once every ten years. Many larger plans have a policy of having an actuarial audit every five years, and a few have actuarial audits more frequently. SDCERS officials indicate that the pension plan has yet to commission an actuarial audit.

An actuarial audit would be different than the actuarial work currently being performed by City actuary Joseph Esuchanko. Mr. Esuchanko is performing specialized reviews at the request of different City departments as opposed to performing a prescribed actuarial audit that is regularly commissioned by the SDCERS Board.

Legislative Body Oversight of Pension Administration

Analysis performed by the SDCERS actuary clearly has budget planning implications for the City Council as the estimated value of pension plan assets and liabilities determines the expected level of the City's contribution to the plan in future years. Despite this important connection, the ability of a legislative body to direct the activities of a retirement board appears to be limited. The IBA has performed a limited review of Article 16 (Section 17) of the California Constitution. This section provides that retirement boards have "sole and exclusive fiduciary responsibility" to administer plans and to manage plan assets in a manner that safeguards benefits/services for plan participants and their beneficiaries. The IBA recommends that the Office of the City Attorney be asked to corroborate this understanding or to further clarify the influence that a legislative body may have over plan administration activities that are overseen by a retirement board.

CONCLUSION

Given the City's pension system history and noting some of the potential weaknesses associated with using one actuary over an extended period of time (cited above), the IBA understands the Kroll recommendation to limit continuous service for a particular actuary at ten years. We also appreciate SDCERS stated intention to rebid the actuarial work every five years and always select the best-qualified actuary for the plan. We have also noted that the California Constitution provides retirement boards with plenary authority and fiduciary responsibility to administer their retirement plans.

The IBA believes that SDCERS can satisfy the general intention of the Kroll recommendation and perhaps satisfy Audit Committee concerns by amending their Board Rules to 1) rebid actuary/service provider contracts every five years, 2) honor their fiduciary responsibility to select the best qualified actuary irrespective of existing consultant relationships, and 3) require a comprehensive actuarial audit be performed every five years by a qualified and competitively selected actuarial firm.

The IBA has shared the above recommendation with the City's Internal Auditor and Jefferson Wells, the Committee's independent audit consultant. Both agree that this action by the SDCERS Board would satisfy the general intention of the Kroll recommendation. The IBA offers this recommendation for the Audit Committee and SDCERS Board to consider.

[SIGNED]

Jeff Kawar
Fiscal & Policy Analyst

[SIGNED]

APPROVED: Andrea Tevlin
Independent Budget Analyst

[SIGNED]

Dominika Bukalova
Research Analyst

MEMORANDUM

DATE: November 24, 2008

TO: Eduardo Luna, City Auditor

FROM: Mark Hovey, SDCERS Chief Financial Officer

SUBJECT: SDCERS Response to Audit Report Regarding Kroll Remediation

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This memorandum is a follow-up response to the August 22, 2008 memo I sent you regarding Kroll's remediation actions for SDCERS, specifically the item pertaining to actuarial retention practices.

Kroll Recommendation Item 99:
To ensure compliance with the Kroll report recommendation, SDCERS should amend its Board policy to include a ten-year limitation on continuous service on contracts for actuarial valuation services, and ensure future renewals with Cheiron, Inc are in compliance with this policy.

SDCERS' August 22, 2008 Response
The terms under which service providers are retained are solely within the purview of the SDCERS Board of Administration. SDCERS' current Board rule permits contracts to have a term of three years, with two optional one-year extensions, unless the party hiring the provider determines otherwise. In June 2006, SDCERS entered into a contract with our actuary for three years, with a five-year renewal option, which was consistent with the "determine otherwise" provision of our Board rule. In July 2008, the Board approved a three-year renewal with Cheiron which is still within the "determine otherwise" provision of the Board rule.

SDCERS plans to amend by December 31, 2008 its policy for hiring service providers such as Cheiron to require a re-bid after five years.

SDCERS' Amended Response
SDCERS' staff is scheduled to recommend to the Board of Administration in December that it amend SDCERS' policy for hiring its actuary to require a re-bid after five years, and to require an actuarial audit by another independent firm to be completed every five years, should SDCERS retain an actuary beyond five years.

There is no requirement or best practice to change actuaries automatically after a certain number of years. The Society of Actuaries (SOA) is the largest professional actuarial organization in the world, and they have no standard requiring actuarial firms rotate off a client after a given period of years. The Government Finance Officers Association (GFOA) recommends that pension plans: 1) have an actuarial experience study performed at least once every five years (SDCERS already does this); 2) have a review of the plan's actuarial valuations performed by an independent actuary at least once every 10 years (SDCERS plans to do this, and Actuarial Service Company, P.C. performed parallel actuarial valuations to Cheiron's FY05 and FY06 valuations and found Cheiron's work to be correct).

Gene Kalwarski of Cheiron, SDCERS' actuary, confirmed that he has not been "termed out" by any client in over 30 years of practice.

William (Flick) Fornia, Senior Vice President of AON Consulting, said he could not recall any systems that have hard term limits for their actuaries. Mr. Fornia said some systems have kept their actuaries for decades, as long as they continue to be well served at a reasonable price. He knew of only one system that routinely changes actuaries periodically, but noted this is an unwise policy because they never get an actuary who is intimately familiar with the plans, the nuances of the Board, and understanding of long term trends.

Karen Steffen, Principal with Milliman Actuaries, agreed that there is no actuarial best practice to rotate firms after so many years. Milliman has had some clients for 40 years, and she is not aware of any clients with a policy to rotate actuarial service providers. She did say that it was a best practice to have an actuarial audit done every five to ten years by another actuarial firm, with five years being more commonplace now.

Jim Godsey is the Macias, Gini and O'Connell audit partner in charge of the SDCERS and City audits. He confirmed that there is no requirement that an accounting firm be "termed out" after so many years. He noted that some small governmental entities rotate audit firms after a period of years, but that this practice was infrequent and not the case for any of MGO's larger clients such as SDCERS.

The California state constitution provides SDCERS with the plenary authority to set their own policy regarding the retention of an actuary. SDCERS believes a request for proposal, done every five years, provides a sufficient opportunity to review competing proposals from qualified actuarial firms. The City's pension plan is one of the more complex plans to be found in the U.S. and there are a limited number of qualified actuarial firms with the necessary expertise to address our needs. Indeed, Cheiron, SDCERS' current actuary, is one of the most qualified actuaries in the U.S., with established relationships with top I.R.S. and tax counsel experts in the fields of governmental pension plans.

Finally, Kroll is an operating unit of Marsh & McLennan Companies, Inc., a global professional services firm. Mercer LLP, also an operating unit of Marsh, provides actuarial consulting services, and Mercer's web site says: "As a wholly owned subsidiary of Marsh & McLennan Companies, Inc., we can also provide access to the complementary services of our sibling companies, Marsh, Kroll, Guy Carpenter and Oliver Wyman." A former employee of Mercer acknowledged that cross-selling was an encouraged practice within Marsh, which this web site statement confirms. While we doubt this affected Kroll's recommendation that SDCERS change their actuary arbitrarily, it might raise the appearance of a conflict of interest given their affiliation with Mercer.

Cc: M. Lewis
A. Tevlin
D. Wescoe

CONTRACTING POLICY FOR GOODS AND SERVICES (OTHER THAN ASSET MANAGERS)

PURPOSE

1. To establish the Board's policy for selecting and contracting with service providers to perform services for the System and for contracts for acquisition of goods.

DEFINITIONS

2. Definitions:

   a. For purposes of this Policy, "Service Provider" and "Provider" means custodial banks, actuaries, outside attorneys and any other businesses or individuals hired by the Board, other than asset managers, to provide professional services to SDCERS. The selection and hiring of asset managers is governed by the Investment Guidelines.

   b. For purposes of this Policy, "Goods" means any personal property, excluding money, securities or negotiable instruments, involved in trade or commerce.

   c. For purposes of this Policy, "Actuary" means SDCERS' primary actuary retained to perform regular actuarial services on an ongoing basis and does not include any independent actuary retained to audit the services of the primary actuary.

POLICY

3. **Contracts with Service Providers and for Acquisition of Goods**

   a. **Fiduciary Counsel, Actuary, Auditor and Custodial Bank:** Only the Board may select and hire Fiduciary Counsel, the Primary Actuary, the Primary Auditor and Custodial Bank. The Board must issue an RFP and conduct interviews for these Providers

   b. **Contracting With Other Service Providers and for Acquisition of Goods:** All contracts for acquisition of goods and for services of non-City or non-City Agency services, including Providers not named in the preceding paragraph will be selected and contracted with as follows:

      1) If the estimated annual cost of the contract is $50,000 or less, the Administrator/CEO may select and contract with the Provider. The Administrator/CEO may determine whether to sole source,

select from a list of candidates pre-qualified by staff or issue an RFP. If immediate action is required on a contract of $50,000 or less and the Administrator/CEO is unable or unavailable to act for any reason, the Chief Financial Officer or the President may act in place of the Administrator/CEO.

2) If the estimated annual cost of the contract is over $50,000 and less than $100,000, the Board may select and contract with the Provider, or may delegate this authority to the Administrator/CEO, or to a committee of the Board. The party who selects and contracts with the Provider may determine whether to sole source, select from a list of candidates pre-qualified by staff, issue an RFI or issue an RFP. Where authority to contract with the Provider is delegated by the Board to another, the party who selects and contracts with the Provider will report the terms of the contract to the Board.

3) If the estimated annual cost of the contract is $100,000 or more, only the Board may select and contract with the Provider. The Board must either issue an RFP and conduct interviews or direct staff to issue an RFP, conduct interviews and report back to the Board with recommendations.

4. **Term of Contracts:** Unless the party selecting the Provider determines otherwise, all Provider contracts will contain the following terms:

a. **Contracts Other Than Fiduciary Counsel, Actuary, Auditor and Custodial Bank:** Except for contracts for professional services of Fiduciary Counsel, Actuary, Auditor and the Custodial Bank, that the contract be for a period of no more than three years, with two optional one year extensions. At the expiration of the contract, the Board will determine whether to renew the contract or, if applicable, issue a new RFP. A contract for a one-time acquisition of goods need not contain a time period.

b. **Contracts for Services of the Actuary:** For contracts pertaining to actuarial services provided by the SDCERS' Actuary, that the contract, and any renewals, be for a period of no more than five consecutive years. At the expiration of the contract for actuarial services, the Board will issue a new RFP. Should SDCERS retain the same Actuary for a term beyond five consecutive years, SDCERS will conduct an audit of the Actuary's services by an independent actuarial firm at least every five years.

c. **Termination:** That the Administrator/CEO or the Board may terminate the contract upon 30 days notice, with or without cause.

5. **Monitoring Service Provider Services and Performance:**

   d. The Administrator/CEO will monitor the performance and services provided by all Providers on an ongoing basis.

   e. For each Provider that has billed SDCERS for more than $50,000 in the last fiscal year, the Administrator/CEO will prepare for the Board an annual written report of the performance, level of service and actual fees paid to each Provider.

POLICY REVIEW AND HISTORY

6. The Board will review this Policy at least every three years to ensure that it remains relevant and appropriate.

7. This Policy replaces former Board Rule 7.70 and was adopted by the Board of Administration on December 19, 2008.